In the early period of performance pricing, creditworthiness (and, therefore, rates) were determined principally by accounting metrics, most commonly the ratio of company debt to earnings, with grids specifying higher rates as a firm's ratio increased ...

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About 25 years ago an important innovation emerged in banks' lending to companies. In contrast to the traditional practice of charging fixed interest rates based on centrally adopted benchmarks, like LIBOR or the prime rate, banks increasingly adopted a more flexible process called “performance pricing.” The new

25% in the late 1990s – interest rose or fell based on companies’ credit ratings.

Now, drawing on more recent data, a study in the December issue of the American Accounting Association journal *Accounting Horizons* suggests that the role of credit agencies in performance pricing has increased considerably and that their expanded role leaves much to be desired.

The new study finds interest rates to be based on credit ratings (PPrating, as the practice is called) in about 56% of the cases of performance pricing. And, most pertinently, the research finds PPrating significantly linked to financial manipulation by corporate borrowers, who thereby succeed in substantially lowering their interest costs.

In the words of the study, by Xia (Eliza) Zhang of the University of Washington, Tacoma, “the potential for large interest rate changes and significant debt cost savings associated with credit-rating movement…gives borrowers strong incentives to influence their firm ratings…Credit-rating agencies do not fully adjust to these managerial opportunistic behaviors.”

Prof. Zhang finds that firms carry out this manipulation by artful management of two major aspects of corporate accounting – accruals, non-cash accounting items that can affect earnings, such as revenues from credit sales or estimated value of inventory; and, more surprisingly, cash flow from operations (CFO), a measure of cash generated from company revenues.

The latter, the professor observes, is particularly noteworthy. “Numerous accounting textbooks and investment advisors,” she writes, “recommend using CFO as a benchmark to evaluate earnings quality.” Further, “credit-rating agencies emphasize cash flow analysis as one of the most critical aspects of rating decision-making, because they believe debt is serviced out of cash [as distinct from earnings] and cash

emerged of CFO or accrual manipulation being associated with performance pricing that was based directly on accounting metrics. As Prof. Zhang writes, "I examine whether PPrating firms are more likely to undertake CFO and accruals management than firms with accounting-based performance pricing provisions…Although [the latter] could also have the incentive to manage CFO and accruals, they should overall have a weaker incentive to do so…[Results] are consistent with my prediction…that PPrating firms are more likely to achieve better ratings through CFO and accruals management."

Coming a decade after credit agencies were widely condemned for issuing deeply flawed ratings of mortgage-backed securities, with dire economic consequences, do the study's findings represent a further blot on the industry? Prof. Zhang demurs, observing that credit agencies readily acknowledge their limitations as auditing agents. Still, the new findings, she says, should certainly be of concern to the credit industry as well as to the banking industry and regulators.

And all of them, the professor reiterates, should take particular note of the success companies enjoy through manipulation of cash flow, a feat that seems to defy conventional wisdom.

In at least one respect, though, the agencies show themselves equal to PPrating firms' financial manipulations – namely, when the grid incorporated in the lending contract indicates the company can lower its interest rate markedly through an improved credit score. "When a larger benefit is associated with inflated ratings," Prof. Zhang writes, "credit agencies could well understand such incentives… Therefore, [they] could impose more scrutiny in this scenario, which could lead to a less pronounced association between CFO and accruals management and ratings. The results are consistent with this conjecture."

In other words, munificent grids become red flags, leading credit agencies to

amount firms exceeded norms for CFO and accruals as estimated in prior accounting research. The increased propensity of PPrating borrowers to engage in financial manipulation compared to companies with accounting-based performance pricing emerged from analysis that included firms in both groups.

The paper, "Do Firms Manage their Credit Ratings? Evidence from Rating-Based Contracts," is in the December issue of ***Accounting Horizons***, published quarterly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review, Auditing: A Journal of Practice and Theory, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*

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